OnPoint Dechert LLP

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A Legal Update from Dechert's Employee Benefits and Executive Compensation Group

Exchanges Propose Rules for Compensation Committees under Dodd-Frank: NASDAQ Issuers Face Heightened Requirements

Recently, the NYSE and NASDAQ issued proposed rules implementing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and SEC Rule 10C-1 governing compensation committees of listed companies. The proposed rules affect three distinct areas: 1. independence of compensation committee members, 2. independence of compensation committee consultants, legal counsel and other advisers, and 3. compensation committee charters and committee authority. The major changes in each of these areas are discussed briefly below.

As a result of the changes, NASDAQ listed companies, depending upon their current compensation committee policies and procedures, potentially face bigger changes than their NYSE counterparts. This is primarily because the NYSE rules prior to the Dodd-Frank Act were more developed and closer in line with the Dodd-Frank Act standards. Additionally, though the rules of both exchanges are subject to SEC approval, certain provisions of the NASDAQ rules are effective immediately while the NYSE's rules are effective in 2014. Therefore, NASDAQ listed companies should be aware that time is of the essence in reacting to the new rules.

Independence of Compensation Committee Members

The Dodd-Frank Act requires that compensation committees be composed solely of independent directors. NASDAQ did not previously have a requirement that listed companies have a designated compensation committee. Rather, executive compensation matters could be decided by a majority of a board's independent directors. Therefore, the NASDAQ rules introduce a new requirement that each listed company have a compensation committee consisting of at least two independent directors and a formal written compensation committee charter that is to be reviewed on an annual basis. The existing NYSE rules already require listed companies to have a compensation committee comprised of independent directors and specify content for a compensation committee charter. Thus, whereas for the NYSE, the Dodd-Frank Act merely requires further clarification of the applicable compensation committee rules, more marked changes are required for NASDAQ.

Under the proposed rules, the boards of both NYSE and NASDAQ listed companies must make an affirmative determination that each member of the compensation committee is independent, and specifically must consider, together with other factors, 1) whether the director is affiliated with the company or any of its subsidiaries or affiliates, and 2) any compensation received by the director, as consulting, advisory, or other fees from the company. With respect to the second factor, the NYSE rule is more lenient: while the NYSE merely uses consulting, advisory, and other fees received from the company as a consideration in determining independence, NASDAQ disqualifies any director who receives such fees, unless the fees or compensation received are for serving as a member of the board or any board committee, or under a retirement plan.

Both exchanges allow for a cure period such that a director that is no longer independent by reason of an act beyond that director's control may remain on the committee for a limited time—the earlier of the next annual shareholder's meeting or one year from the event that caused the director to fail to be eligible to be on the committee. (NASDAQ allows the ineligible director to remain on the committee for up to 180 days if the next shareholders meeting will occur within that time frame).

Independence of Compensation Committee Consultants, Legal Counsel and Other Advisers

Public companies and their boards have for some time been concerned about the independence of their executive compensation consultants. However, the Dodd-Frank Act enlarged the scope of the inquiry to include the independence of outside legal counsel and other advisers engaged by the compensation committee. In addition to broadening the field of advisers covered by the inquiry, the Dodd-Frank Act created a six-factor list, adopted by the proposed rules of both exchanges, that is to be used in making a determination of whether any compensation committee adviser is "independent." The six factors that must be considered are

1. the provision of other services by the adviser's employer to the listed company;
2. the amount of fees received by the adviser's employer, as a percentage of total revenue, from the listed company;
3. policies and procedures of the adviser's employer that are designed to prevent conflicts;
4. business or personal relationships between the adviser and compensation committee members;
5. the adviser's holdings of the issuers stock; and
6. business or personal relationships between the executives of the listed company and the adviser or the adviser's employer.

While these six factors must be considered by all compensation committees, no single factor is dispositive and an adviser may be retained despite the presence of some of the factors. However, the Dodd-Frank Act requires proxy-statement disclosure of any conflicts of interest raised by engagements of compensation committee advisers, and how those conflicts were addressed.

Compensation Committee Charter and Committee Authority

As noted above, prior NASDAQ rules did not expressly require listed companies to have a compensation committee or a charter. The proposed NASDAQ rule requires the establishment of a compensation committee with at least two independent directors and a charter that specifies the compensation committee's responsibilities, structure, processes, and membership requirements. The new rules also provide that the CEO may not be present when the committee is deliberating or voting on CEO compensation.

In addition to requiring that each listed company establish a compensation committee with an annually reviewed charter, SEC Rule 10C-1 requires that compensation committees must have the authority, in their sole discretion, to retain compensation consultants, independent legal counsel and other compensation advisers. Further, listed companies must provide appropriate funding, as determined by the compensation committee, for any advisers the compensation committee engages. Compensation committee charters must incorporate express provisions to this effect. However, both exchanges emphasize that compensation committees are not required to retain independent advisers.

In light of heightened scrutiny and the increasingly detailed regulation of compensation committees, all listed companies should review their policies and procedures and modify their compensation committee charters accordingly.

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